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The Dangerous Dollar

George Bush hasn't much discussed what could be his biggest economic problem. It's not budget deficits or jobs. It's the possible crash of the dollar on foreign exchange markets. Even if Bush understood it, he would be hard-pressed to explain it to the public. Worse, there are no obvious ways to prevent it. Nor is it certain how big the threat is. Little wonder Bush hasn't said much. If John Kerry had won, the situation would have been the same. But a dollar crash, if it occurred, could trigger a terrifying global slump.

The dollar lubricates the world economy, having replaced gold as the major international currency. Huge amounts of trade and cross-border investment are conducted in dollars. In some form, a "dollar problem" has long existed. After World War II there was a "dollar gap": Europe and Japan didn't have enough dollars to import the food and machinery needed for recovery. The United States filled the gap with foreign aid and policies encouraging multinational American firms to invest abroad. These policies provided dollars, although the United States still ran big trade surpluses. Actually, foreigners often used the dollars to buy American goods.

The problem now is similar and different. As in the 1950s, today's outflow of dollars stimulates the global economy. Unlike the 1950s, it involves huge U.S. trade and current account deficits. (The "current account" includes trade plus other "current" overseas payments, such as travel, freight costs and dividend payments.) In 1990 the U.S. current account deficit was $79 billion, or 1.4 percent of gross domestic product. In 2004, it's expected to hit an unprecedented $665 billion, or 5.6 percent of GDP, says economist Nariman Behravesh of Global Insight. The ballooning deficit has two basic causes.

First, the American economy has grown faster than other advanced economies. Since 1990 U.S. economic growth has averaged 3 percent annually, compared with 2 percent for the European Union and 1.7 percent for Japan. America's higher growth sucks in imports; Europe's and Japan's slower growth hurts U.S. exports.

Second, the global demand for dollars props up its exchange rate, making U.S. exports more expensive and U.S. imports cheaper. Indeed, many countries, particularly in Asia, fix their currencies to keep their exports competitive in the U.S. market. Instead of allowing surplus dollars to be sold on foreign exchange markets—lowering the dollar's value—government central banks in Japan, China and other Asian countries have purchased more than $1 trillion of U.S. Treasury securities. Private investors have also bought lots of U.S. stocks and bonds. All told, foreigners own about 13 percent of U.S. stocks, 24 percent of corporate bonds and 43 percent of U.S. Treasury securities.

Up to a point, this arrangement benefits everyone. The world gets needed dollars; Americans get more imports, from cars to clothes. But we may now have passed that point. Hazards may outweigh benefits. The world may be receiving more dollars than it wants. A sell-off could spill over into the stock and bond markets and cause a deep global recession. Here's how.

Foreign traders and investors sell dollars on foreign exchange markets. The dollar declines in relation to the euro, the yen and other currencies. The dollar's decline means that the value of foreigners' investments in U.S. stocks and bonds—measured in their own currencies—is also dropping. So foreigners stop buying U.S. stocks and start selling what they have. The stock market drops sharply.

Presto: the makings of a global recession. The stock market slide causes American consumer confidence and spending to weaken. If foreigners also flee the bond market, long-term interest rates on bonds and mortgages might rise. Higher currencies make Europe's and Japan's exports less competitive. Their industries stagnate. The United States, Europe and Japan constitute about half the global economy. Their recessions would hurt the Asian, Latin American and African countries that export to them. Markets interconnect; weakness spreads. It's grim.

Note, however, that the dollar's vulnerability is a symptom of something else: the addiction of Europe and Asia to exporting to the United States. If their economies grew faster on their own, the massive U.S. payments deficits wouldn't have emerged. The dollar would have quietly drifted down. Foreigners would have invested less in the United States, because they'd have more investment opportunities at home. But Europe suffers from suffocating taxes and regulations. Japan has long favored export-led growth. And about 35 percent of China's exports go to the United States, says economist Nicholas Lardy.

There's a stubborn contradiction. The world may be getting more dollars than it wants, but it likes the source of those dollars: large U.S. trade deficits. China has resisted U.S. pressure to raise the value of its currency; Europeans and Japanese deplore the recent increases in their currencies. Because the dollar's vulnerability reflects other countries' weaknesses, no American president can cure it alone. Contrary to popular wisdom, for example, U.S. budget deficits don't cause U.S. trade deficits. In the late 1990s, trade deficits widened even though budget deficits declined.

No one knows what will happen. The massive U.S. payments deficits could continue for years, with foreigners investing surplus dollars in American stocks and bonds. Gradual shifts in currency values might reduce the world's addiction to exporting to the United States. Or something might cause a dollar crash tomorrow. In that case, massive intervention by government central banks (buying unwanted dollars) might avert a calamity. Or it might not. We're in uncharted waters. If we hit a shoal, it will be bad for everyone.